

I. TYPES OF ACCOUNTS

The cash accounts include U.S. and foreign currency and coin on hand or in transit, clearings, and cash items. The phrase "due from banks" is used to describe bank assets that consist of demand and time deposits maintained in other banks to facilitate the transfer of funds. The comments immediately following provide greater detail as to the important characteristics of these asset accounts.

Cash

Every bank must maintain a certain amount of U.S. and/or foreign currency and coin on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers, with a reasonable allowance made for unusual demands. *Part 326 of the FDIC Rules and Regulations requires that procedures for the safekeeping of currency be established.*

Clearings

Clearings are checks, drafts, notes and other items a bank has cashed or received for deposit that are drawn on other local banks, and cleared directly with them. Such items usually can be exchanged more efficiently between or among local banks than through correspondent banks or the Federal Reserve System. Many communities with two or more banks have organized formal clearinghouse associations which have adopted rules governing members in the exchange of checks. Such associations often extend those arrangements to banks in other nearby cities and towns.

In most banks, clearings will be found in the department responsible for processing checks. Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. In recent years, many banks have combined those two functions, which may be centralized or decentralized, manual or automated, depending upon the size of the bank and the volume of transactions. However, no matter who performs the function or how large the

bank, the objectives of a proof and transit system are the same: to forward items for collection so that funds are available as soon as possible; to distribute all incoming checks and deposits to their destinations; to establish whether deposit totals balance with the totals shown on deposit tickets; to prove the totals of general ledger entries and other transactions; to collect data for computing the individual customer's service charges and determining the availability of customer's funds; and to accomplish the assigned functions at the lowest possible cost.

Cash Items

Cash items are checks or other items in process of collection payable in cash upon presentation. A separate control of all such items is generally maintained on the bank's general ledger and supported by a subsidiary record of individual amounts and other pertinent data. Cash items and related records usually are in the custody of one employee at each banking office who is designated as the collection, or exchange, teller.

In normal daily operations, all banks have an internal float of assets charged, on the general ledger, to the total debit to demand deposits but which cannot be charged to individual accounts because of insufficient funds, no accounts, etc. Such items are commonly known as bookkeepers' return items or rejected or unposted debits and may consist of checks received in the ordinary course of business, loan payments and other debit memos. In some banks, such items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled "bookkeepers' return items". Other banks do not use a separate asset account, instead the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank returns the checks to their sources.

Since bookkeepers' return items usually can be returned on the following business day, the balance of the bookkeepers' return item account should represent the total of only one day's items.

When data processing systems are in use, it is common practice to post all properly encoded debit items, regardless whether an overdraft is created. The resulting preliminary overdraft list,

together with the items charged, is then reviewed by bank employees and unapproved items reversed and separated as bookkeepers' return items. The total of the resulting final overdraft list becomes the final overdraft figure shown on the general ledger.

Cash items not in process of collection should be included on the bank's books in an appropriate account and shown under "other assets". These items, such as Series E Bonds, are payable upon presentation but the bank has elected to accumulate them for forwarding to the payer on a periodic basis. If the items are not immediately payable in cash upon presentation, or were not paid when presented and, after a predetermined period of time, require further collection effort, they also should be included in a noncash asset account, such as "suspense accounts", and shown under "other assets". Examples are checks held to avoid overdrafts and other checks for which there are no funds for immediate payment. Many banks establish a three-day limit, after which all items not collected must automatically be transferred from "cash items" to "suspense accounts". Refer to the Other Assets Section of this Manual for additional comments on cash items not in process of collection.

Due From Banks - Demand Balances

These assets are also commonly referred to as "correspondent bank balances". These accounts enable the transfer of funds between banks, resulting from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of Federal funds, and from many other causes.

Due From Banks - Time Balances

These assets include time balances with any bank (including private banks, both domestic and foreign), which are not subject to immediate withdrawal but have the usual time account restrictions.

Banks also utilize other banks to provide certain services which can be performed more economically or efficiently because of their size or geographic location. Such services include processing of cash letters, packaging loan agreements, funding overline loan requests for customers, performing EDP and payroll services,

collecting out-of-area items, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one way, the bank receiving that service usually maintains a minimum or compensating balance in full or partial payment for the services received.

Reciprocal interbank deposits occur when two banks maintain deposit accounts with each other. When these deposit relationships involve demand deposits, the "net" effect should be shown in the examination report (reciprocal time balances should be shown "gross"). Combining all demand deposit accounts "due from" each bank and aggregating all demand deposit accounts "due to" each bank, will determine the net "due from" or "due to" position.

Some banks have purchased "deposit notes" as investments. These instruments are a form of deposit liability somewhat similar to negotiable time certificates of deposit (CD). "Deposit Notes" have been structured like corporate bonds by having a five-day corporate settlement period for purchases and semiannual interest payments calculated on a 30/360 - day basis. Although maturities vary from nine months to 15 years, most "deposit notes" mature in four to seven years. While the foregoing contract terms could be incorporated into a CD, certain banks, for marketing purposes, prefer to use the "deposit note" format.

Bank purchases of such notes should be made in accordance with established investment and asset/liability management policies. While these note issues tend to be rated, banks considering the purchase of a "deposit note" should nonetheless obtain the offering circular or other similar information to ensure that they understand the nature of such notes (including possible deposit insurance coverage) before investing. A bank's investment in a "deposit note" should generally be included on the balance sheet in the interest-bearing balances due from depository institutions asset category. However, if the offering circular or note instrument for a particular "deposit note" is available for review and it does not contain a statement to the effect that the liability represented by the note is a deposit liability of the issuing bank, the bank's investment in the note should be treated as a security or a loan based on the characteristics of the note.

II. EXAMINATION OBJECTIVES

Examination interest in the cash and due from bank accounts stems from four main considerations discussed below.

Primary Reserves

For all practical purposes, primary reserves consist of cash and demand balances due from other banks. These accounts generally represent a bank's most liquid assets, except to the degree that they comprise a bank's "required" or statutory reserves. Held in this capacity, they lack the flexibility generally associated with liquidity reserves, which is covered in greater depth in the Liquidity and Funds Management Section of this Manual. Excessive cash or due from bank (demand) balances can have an adverse effect on earnings inasmuch as these funds provide no income for the bank. Conversely, too low balances in these accounts could obviously leave the bank in an untenable position from an available funds standpoint. The examiner should therefore ascertain if the amounts carried in these accounts are reasonable in relation to the institution's primary reserve requirements. Some assistance in making this assessment may be obtained by referring to the UBPR. This report includes a schedule on percentage composition of assets and liabilities; that is, how the bank has structured its balance sheet in terms of percentages devoted to loans, demand deposits, cash and due from banks, and all other asset and liability categories. The data are available over a five-year period and include peer group comparisons. If the bank's commitment in the cash and due from bank accounts appears considerably out of line with those of the peer group (after taking into account the bank's reserve requirements), or if the percentage has markedly changed (current vs. previous examination), further investigation may be warranted. Excessive balances which are significantly harmful to earnings may reflect ineffective administration of the bank's resources by management or in some instances may even be indicative of abusive compensating balance arrangements discussed below.

Internal Control

Shortcomings in the bank's procedures and controls, as they relate to cash and due from bank

accounts, can lead to manipulation and shortages. Hence, an evaluation of those controls is a part of every examination. The reader is referred to the Internal Routine and Controls Section of this Manual where this subject is treated at some length.

Policies and Procedures on Interbank Liabilities

Section 308 of the FDIC Improvement Act of 1991 requires all insured institutions to establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent. The Federal Reserve's Regulation F (12 CFR Part 206), Limitations on Interbank Liabilities, implements this law. This rule covers all "credit exposure" to a correspondent. The rule provides detail concerning prudential standards for internal policies and procedures to identify and control risk. They should address the risk arising from exposure to a correspondent, taking into account the financial condition of the correspondent and the size, form, and maturity of the exposure. The bank's board of directors must review annually the bank's policies and procedures concerning correspondents.

The rule requires that a bank take into account any deterioration in the condition of a correspondent in evaluating the creditworthiness of the correspondent. The rule requires that a bank establish internal limits on exposure only where the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payment will not be made as contemplated. Limits must be consistent with the risk undertaken, but may be flexible, based on factors such as the level of monitoring of the exposure and the condition of the correspondent.

The rule provides that a bank should limit overnight credit exposure to a correspondent to 25 percent of the exposed bank's capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized." The rule does not specify limits for credit exposure to adequately or well-capitalized correspondents. However, the 25% limit is phased-in over time and does not become effective until June 19, 1995.

Concentrations

Application of the principal of adequate risk diversification in the bank's asset structure is not

restricted to loans or securities but can also be of some importance in the analysis of due from bank accounts (demand and time balances). When the aggregate of demand and time balances due from and Federal funds sold to one financial institution or affiliated group equals or exceeds 100% of the bank's Tier 1 Capital, a Concentration should be scheduled in the examination report. One exception to this general instruction applies. To the extent that excess funds sold are collateralized by securities issued by the U.S. Treasury or U.S. Government agencies, by other obligations that are backed by the U.S. Government, or are fully guaranteed as to payment of principal and interest by the U.S. Government, the amount so secured should not be scheduled as a Concentration.

It must be remembered that in listing a due from bank account in the Concentrations schedule, the intention is not to arouse concern over the soundness of the bank with which the account is maintained. Rather, the objective is to inform bank management of a possible contravention of prudent diversification practices and thereby stimulate the review of same. If it is the examiner's intent to criticize those diversification policies, appropriate comments should be added to the schedule. Notwithstanding the foregoing remarks, there is a credit risk factor present in all correspondent bank relationships (at least to the extent that account balances exceed the limits of deposit insurance coverage), and it is therefore considered necessary and prudent for bank management to make an intelligent analysis of this creditworthiness element.

One other consideration is necessary when analyzing a concentration in the due from bank (demand) accounts. To adequately compensate the correspondent institution for various services it provides, a certain level of collected balances is necessary. This amount may well be considerably less than the amount shown on the books of the bank being examined, in part because of certain timing differences associated with the processing of incoming and outgoing cash letters. As a result, the correspondent account balance frequently exceeds the 100% threshold. Consequently, although it is appropriate to inform bank management of concentrations in the due from bank (demand) accounts, diversification policies should not be criticized by examiners when the account balances maintained are consistent with the institution's legitimate business needs.

Compensating Balances

Under the provisions of Part 349 of the FDIC Rules and Regulations (refer to the Management Supervision, Administration and Control Section of this Manual), executive officers and principal shareholders are required to report the terms and amounts of their indebtedness to correspondent banks to their respective board of directors. The purpose of this regulation is to aid in the determination of preferential lending practices to executive officers, directors, and principal shareholders of a bank where a correspondent relationship exists.

As stated earlier, maintenance by one bank of an appropriate deposit account with another bank is essential to the conduct of banking business. However, officers, directors, or principal shareholders of the depositing bank may abuse their position by causing an amount in excess of the bank's reasonable correspondent needs to be maintained in such a correspondent account and then trade off its economic power for their own financial benefit. Such an arrangement may, depending on the circumstances, constitute a breach of a bank official's fiduciary obligations to the depositing bank and thus to its depositors, creditors and shareholders; in some cases, the arrangement may also involve a criminal offense.

Accordingly, if the bank maintains a correspondent account with another bank which has extended credit to any of the above persons or anyone associated with them or the examiner discovers that the bank holds a deposit from another bank and has outstanding extensions of credit to such persons in the other bank or their associates, and where there is evidence that the depositing bank may have suffered a detriment because of the loan/deposit arrangement, the situation should be thoroughly investigated. Refer to the Bank Fraud and Insider Abuse Section for further information.